

The International Comparative Legal Guide to:

Corporate Governance 2008

A practical insight to cross-border corporate governance



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1 Setting the Scene - Sources and Overview

1.1 What are the main corporate entities to be discussed?

The main corporate entities to be discussed are: (i) publicly held companies (“**PHCs**”); (ii) banking institutions (“**Banks**”); (iii) holding companies of financial groups (“**FG Holding Co.**”); (iv) broker dealers (“**Broker Dealers**”); and (v) investment funds (“**Investment Funds**”). However, other entities such as private companies or non-publicly held companies or corporations (“**NPHC**”) and non-profit entities should be discussed as well.

1.2 What are the main legislative, regulatory and other corporate governance sources?

The best practices of corporate governance, provided in the “Mexican Code of Best Practices of Corporate Governance” (the “**Code**”), are intended to be adopted not only by PHCs but also by NPHCs and even by non-profit entities. The Code was issued in 1997 as a consequence of a joint effort by the Business Coordinator Board (*Consejo Coordinador Empresarial*) (the “**CCE**”) and the Mexican National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*) (“**CNBV**”) and it was recently updated in 2006 by the CCE. The provisions contained in the Code are not mandatory and can be voluntarily adopted by any private companies or entities. The Code is originally based on other codes of best practices of corporate governance, among others, the Cadbury, Greenbury and Hampel Reports from the UK, the “*Vienot Report*” from France and the “*Código de las Sociedades Cotizadas*” (*Código Olivencia*) of Spain. Corporate governance guidelines of the California Pension Retirement System (CalPers), and the GE corporate governance guidelines were also an important basis for the Code. Also, the Combined Code of the UK and the corporate governance rules of the OCDE had certain influence in the revised Code.

However, as a consequence of a process initiated in 2001, some special laws such as the Stock Exchange Law (*Ley del Mercado de Valores*) (the “**Exchange Act**”), the Banking Institutions Law (*Ley de Instituciones de Crédito*), the Law Ruling Financial Groups (*Ley para Regular las Agrupaciones Financieras*) and the Investment Funds Law (*Ley de Sociedades de Inversión*), among others, adopted several of the recommendations of the Code to make them mandatory. Hence, such best practices of corporate governance became mandatory to Bank Broker Dealers, PHCs, FG Holding Co. of financial groups and investment funds. Therefore, the target companies must include in their corporate bylaws those provisions regarding the mandatory best practices of corporate governance provided to in said laws (i.e. some entities must form a committee

dealing with audit functions (“*Comité de Auditoría*”) and in some other cases corporations may form a Corporate Practices Committee (“*Comité de Prácticas Societarias*”).

A new Exchange Act was enacted in 2006 and such best practices of corporate governance are still mandatory as being provided in such Exchange Act. Additionally, other rules concerning corporate governance of PHCs, Broker Dealers, deposit trust companies, and the exchange itself are contained therein. Regulations issued by the CNBV also provide certain corporate governance matters related to PHCs and other financial entities. Rules of the Mexican Stock Exchange (*Bolsa Mexicana de Valores*) (“**BMV**”) provide that all the information concerning the fulfilment of the best practices of corporate governance described in the Code shall be disclosed to the investors for them to rate the issuers they are intending to invest in.

Regarding corporate governance practices of financial entities (i.e. Banks, FG Holding Co., Broker Dealers, Investment Funds, etc.) the special law ruling such kind of entities provides for specific mandatory provisions. Therefore, the Banking Act (*Ley de Instituciones de Crédito*) contains provisions for the corporate governance practices of Banks. The Law Ruling Financial Groups provides rules for the corporate governance of the FG Holding Co. The Investment Funds Act provides for corporate governance rules of Investment Funds, etc.

1.3 What are the current topical issues and trends in corporate governance?

Mexico was one of the first countries in Latin America adopting a code of best practices of corporate governance. As mentioned above, the Code was issued in 1997 and updated in 2006 by the CCE. The main topics of the Code and the updated Code are not materially different. Both revisions of the Code have the following main topics: (i) protection of minority rights at shareholders’ or partners’ meetings; (ii) the powers or duties of the Board of Directors or Board of Partners; (iii) the membership into the Board of Directors or the equivalent corporate body in any entity different from Mexican corporation; (iv) the structure of the Board of Directors; (v) the operation of the Board of Directors; (vi) the responsibility of the members of the Board of Directors; (vii) the Audit Committee (*Comité de Auditoría*); (viii) the Compensation and Remuneration Committee (*Comité de Compensación and Remuneración*); and (ix) the Finance and Planning Committee (*Comité de Finanzas y Planeación*).

The objective of the best practices of corporate governance adopted either voluntarily or mandatorily by certain entities, is to achieve transparency, find a balance in the Board of Directors and have effective minority rights.

2 Shareholders

2.1 What rights and powers do shareholders have in the operation and management of the corporate entity/entities?

The GLBO provides that the shareholders' meeting is the supreme decision corporate body in a Mexican corporation. However, the management is delegated to the Board of Directors and the day-to-day operations to the management. It is important to bear in mind that some corporate matters can be exclusively resolved by the shareholders (i.e. amendment to the corporate bylaws, the annual remuneration of the members of the Board of Directors, the approval of the financial statements of the company, etc.).

The shareholders' meeting has the same powers in PHCs but additionally the shareholders must resolve on the following matters: (i) authorisation of transactions with subsidiaries the value of which is equal to 20% or more of the value of the company's assets; and (ii) appointment of the presidents of the Audit Committee and, in its case, of the Corporate Practices Committee.

2.2 Do indirect shareholders (e.g. beneficial shareholders who hold through nominees), have direct rights in relation to the corporate entity/entities?

Usually beneficial owners of shares holding through an intermediary do not attend to the shareholders' meeting to exercise shareholders' rights; indirect shareholders do not have direct rights in the entity. Nonetheless, shareholders may in practice exercise their rights directly (but on behalf of the direct shareholders) without the participation of the intermediary if they are willing to do so. Likewise, the intermediary shall issue an access pass to the shareholders' meeting in favour of the corresponding shareholder.

2.3 Are there any limitations on, and disclosures required, in relation to interests in securities by shareholders?

In principle, there is no restriction as to the shares or securities an individual can hold. However, the Exchange Act provides for some provisions ruling the acquisition, either directly or indirectly, of at least 30% of the capital stock of the PHC they are related to. In the case that a shareholder is intending to acquire at least such percentage, he/she/it must publicly offer to purchase stock representing (i) at least the higher of (y) the amount of shares needed to reach such 30% of the capital stock of the PHC, or (z) 10% of the capital stock of the PHC, provided that, derived from such acquisition the offeror does not acquire control of the PHC, or (ii) if acquirer is intending to control the PHC, then the offer to purchase must be for 100% of the capital stock of the PHC.

Certain transactions with related parties must be disclosed to the market. Any transaction or transactions by which any person or group of person acquires (who act jointly) at least 10% but not more than 30% of the capital stock of a PHC, must be disclosed to the exchange market. Such disclosure is mandatory within the next following business day after that one in which the transaction takes place.

Any transaction involving a related person or related group of persons by which shares representing at least 5% of the capital stock of the PHC they are related with are transferred, must be disclosed to investors within the next business day.

The CNBV is entitled to issue regulation ruling the disclosure of such transaction.

2.4 What shareholder meetings are commonly held?

Commonly a general ordinary shareholders' meeting is held annually to review and approve the financial statements, appoint the members of the administrative body and the administration oversight body, if any. Additionally, such meeting resolves on the remuneration, if any, to both the administrators and the Statutory Auditor in case of the NPHC. If amendments to the corporate bylaws are intended to be in effect then a general extraordinary shareholders' meeting must be held. The general extraordinary shareholders' meeting must be held to discuss any of the following matters provided to in the GLBO, or any other matters provided to in the specific corporate bylaws of the relevant corporation.

The general extraordinary shareholders' meeting must be held to discuss:

- A. an extension of the duration of the corporation;
- B. the dissolution of the corporation;
- C. an increase or reduction of the capital stock;
- D. a change of the corporation's purpose;
- E. a change of the corporation's nationality;
- F. transformation (the conversion of the corporation from one business type to another);
- G. its merger with another corporation or spin-off;
- H. the issuance of preferential shares;
- I. the redemption by the corporation of its own shares and issuance of beneficial shares;
- J. the issuance of bonds;
- K. any other modification of the bylaws; and
- L. any other matter for which a special quorum is required by the corresponding bylaws or law.

Any other matter to be discussed must be resolved by the general ordinary shareholders' meeting.

2.5 Can shareholders call shareholder meetings or put resolutions?

In the case of Mexican corporations (*Sociedad Anónima*), the Board of Directors and the statutory auditor (the "**Statutory Auditor**") of same are entitled to call for shareholders' meetings. Nonetheless, in specific circumstances, shareholders' may request a judge to call for a shareholders' meeting if:

- (1) No appointment of the Statutory Auditor has taken place. In such case, any shareholder holding at least 1 share may request the judge to call for a shareholders' meeting to appoint the Statutory Auditor of the corporation if for any reason the Board of Directors or the sole Director did not call for said meeting even when so requested by such shareholder.
- (2) Shareholders representing at least 33% of the capital stock of a corporation may, at any time, request the Board of Directors or the Statutory Auditor to call for a shareholders' meeting. If neither the Board of Directors nor the Statutory Auditor call for the shareholders' meeting within the 15 calendar days following the request, then such shareholders may request a judge to call for the corresponding shareholders' meeting to discuss any of the matters decided to be discussed by those shareholders.
- (3) The holder of one share may request either the Board of Directors, the Statutory Auditor to call for a shareholders' meeting of a corporation (or a judge if the Board of Directors or the Statutory Auditor of the corporation failed to do so) if: (i) no shareholders' meeting is held within any of the previous 2 fiscal years; (ii) no general ordinary shareholders' meeting has been held within such period to discuss the review and, in its case, approval of the financial statements

of the corporation, the appointment or ratification of the appointment of the Sole Administrator or members of the Board of Directors and the Statutory Auditor of the corporation, and the remuneration of both the Administrators (either the sole administrator or the members of the Board of Directors) and the Statutory Auditor of the corporation.

Holders of stock representing at least 10% of the capital stock of a PHC, may request at any time, to either the chairman of the Board of Directors or the chairman of any of the Audit Committee or the Corporate Practices Committee to call for a shareholders' meeting to discuss any matter.

2.6 Is electronic communication to or by shareholders possible?

Electronic communication from the corporation to the shareholders is possible and legally valid (financial statements, relevant information and generally any other information of an accounting, administrative, economic and legal nature that are the subject matter of disclosure in the case of PHCs). However, some documents cannot be submitted electronically and hard copies need to be in existence. It is important to mention that Mexican law does not allow electronic voting. The physical presence of the attorney-in-fact in the shareholders' meeting is required by law to cast votes. Consequently, no electronic instructions to vote or electronic proxy letters are legally valid. Instead, shareholders can be represented in the corresponding shareholders' meeting with either printed original proxy letters or power of attorney granted before a notary public in the case of private entities or, in the case of PHCs the PHC shall prepare special forms for such purpose. Said forms are available in the domicile of the PHC for investors to be represented in the relevant shareholders' meeting.

2.7 Can shareholders be liable for acts or omissions of the corporate entity/entities?

The main principle is that shareholders' obligations are limited to their contribution to the capital stock to a corporation. Such responsibility is limited as long as the corporation is duly recorded in the Public Registry of Commerce of the corporate domicile. Consequently, if the corporation is not recorded in said registry, the liability of the shareholders for acts of the corporation will be unlimited. Any shareholder acquiring an interest in a corporation that is already operating will be liable for the acts of such corporation even for those previous to the date in which he/she/it acquired an ownership interest in such corporation. Moreover, any shareholder leaving or separated from the corporation will be liable for the pending transactions of the corporation.

Nevertheless, shareholders' are liable to the corporation when acting against the best interest of same. In case of a conflict of interests, the shareholder shall abstain to vote. If the shareholder votes even when having a conflict of interest, then he/she/it shall be responsible and must pay for damages caused. Needless to say, the shareholders may be held liable in the event of fraudulent acts.

2.8 Can shareholders be disenfranchised?

No. In any case they will be liable for acting against the corporation as described in question 2.7 above.

2.9 Can shareholders seek enforcement action against members of the management body?

Yes. The members of the Board of Directors shall be liable before

and accountable to the shareholders for the performance of their duty. As mentioned, the members of the Board of Directors or, in its case, the Sole Administrator, must refrain from voting in any matter in which they have a conflict of interest; otherwise, they will be liable for the damages caused to the corporation. Such liability will be jointly assumed by all the members of the Board of Directors having a conflict of interest. Shareholders representing at least 33% of the capital stock of a NPHC are entitled to claim the payment of damages. In the case of PHCs, the responsibility to pay for damages caused is described in detail in the Exchange Act. Breaching the duties of care and loyalty will make the members of the Board of Directors liable for such breaching and the shareholders will then have the right to seek enforcement actions. Investors holding 5% of the capital stock of a PHC may demand the payment of damages derived from any responsibility in which the members of the management body incur during the performance of their duties.

3 Management Body and Management

3.1 Who manages the corporate entity/entities and how?

In a NPHC, management is entrusted either to a Sole Administrator or to a single, one-tier Board of Directors. The Board of Directors must be integrated at least by two members. All members of the Board of Directors are equally responsible for the board's actions and decisions. There is not a supervisory board in Mexican corporations. Nevertheless, oversight of the administration is entrusted to another corporate body, the Statutory Auditor. The role of supervisor of the administration of a NPHC can be entrusted to either one person or to two or more persons.

The role of Sole Director or of a member of the Board of Directors must be performed personally and cannot be delegated to attorneys-in-fact.

Independent Directors are not mandatory in NPHC.

The Chairman of the Board of Directors of a NPHC may call for a shareholders' meeting and if so decided by the shareholders, he/she may execute the resolutions of the shareholders' meeting.

Duties and responsibilities for any and all of the members of the Board of Directors will be the same. They are accountable and liable for the performance of their duties and responsible for any damage caused to the NPHC.

In a PHC, administration is entrusted to a Board of Directors and to the Chief Executive Officer (the "**CEO**"). The Board of Directors can have a maximum of 21 members. No external auditor for the PHC or for any of its related companies can be appointed as a member or the Board of Directors of a PHC.

Provisional Directors can be appointed on PHCs. Such Provisional Directors can be appointed by the Board of Directors itself when directors are removed. In such a case, the shareholders' meeting must ratify such appointments or appoint the new directors in the next shareholders' meeting to be held.

The Exchange Act provides that the composition of a PHC's Board of Directors must consider at least 25% of Independent Directors. Independent Directors are those appointed as a consequence of its broad and proved experience, capability to run a corporation and their professional recognition and prestige. They must be free of conflict of interests. The Exchange Act provides for some conditions that an Independent Director must not meet to be actually considered as an Independent Director. In that sense, Independent Directors cannot:

- (i) be a former relevant manager or employee of the PHC or of

- any other company belonging to the PHC's corporate group;
- (ii) have significant influence on or decision power in any of the companies forming part of the PHC's corporate group;
- (iii) control shareholders;
- (iv) clients, suppliers, debtors, creditors, partners, directors or employees of any company being at the same time important client, supplier, debtor or creditor. The Exchange Act provides that such client or supplier is important if at least 10% of its total sales during a 12-month period before the appointment of the Independent Director, are related to the PHC. Additionally, a creditor or debtor is important when the relevant credit is equal to at least 15% of the assets of the PHC or its counterparty; and
- (v) is not a blood or in law relative within the 4th level, spouse or couple of any of the persons referred to in items (i) to (iv) above.

The shareholders' meeting is entitled and obliged to determine the effective independent status of each of the members of the Board of Directors of the PHC. Additionally, the CNBV has the authority to challenge the independent status of any of the designated members of the Board of Directors.

Independent Directors must chair the Audit Committee and the Corporate Practices Committee, if any. The Audit Committee must be formed only by Independent Directors and the Corporate Practices Committee must be formed of a majority of Independent Directors. Those committees shall have at least 3 members.

Each member of the Board of Directors has the same duties, responsibilities and liabilities. The Board of Directors, among other duties, must define the general strategies of the PHC, oversee the day-to-day operation of the PHC led by and in charge of the CEO.

Only when Independent Directors are acting in any of the committees will they have additional duties, i.e. those related precisely to any of such committees.

Members of the Board of Directors are accountable and are responsible for the due performance of their duty of care and loyalty. The expected outcome of the members of the Board of Directors' performance is to create value for the benefit of each and all shareholders and for the PHC. Each member of the Board of Directors is liable for any damage caused to the PHC derived from the breaching of any of the duties or loyalty or care. The members of the Board of Directors breaching such duties shall be jointly liable for the damages caused to the PHC. If the members of the Board of Directors breach their duty of care, responsibility for damages can be limited either by the corporate bylaws of the PHC or by its shareholders' meeting. Moreover, the PHC can have insurance covering any malpractice of their administrators when breaching the duty of care. No limitations can be imposed to the responsibility of a member of the Board of Directors if breaching his/her duty of loyalty and no insurance can be acquired by the PHC in case of violation of the duty of loyalty.

Oversight of the administration and of the day-to-day operations of a PHC is entrusted to the Audit Committee and, in its case, to a Corporate Practices Committee.

The **Audit Committee**, among other duties, must: (i) perform an evaluation of the external auditor of the PHC; (ii) discuss the financial statements of the PHC with the persons responsible for preparing them; (iii) inform the Board of Directors of the situation of the internal controls; (iv) furnish an opinion to the Board of Directors in connection with the PHC accounting policies and criteria for further approval of same by the Board of Directors; (v) furnish an opinion to the Board of Directors regarding the appointment and nomination of the CEO; (vi) prepare and form an opinion allowing any director, relevant officer or any person with decision power to carry out a business which naturally belongs to

the PHC; and (vii) define the policies for internal controls for further approval from the Board of Directors.

The **Corporate Practices Committee**, among other duties, must: (i) define the policies for the use of corporate assets of the PHC and related companies by shareholders, Directors and officers; (ii) participate with the Board of Directors in the preparation of reports on accounting policies; (iii) review and opine in connection with transactions with related parties, transactions executed between or among related companies out of the ordinary course of business or that exceed certain amounts; and (iv) prepare an opinion addressed to the Board of Directors regarding the remuneration of the CEO and other relevant officers of the PHC.

The **Chief Executive Officer** manages the day-to-day operations of the PHC and its subsidiaries. The CEO must: (i) submit to the Board of Directors for approval the general strategy of the business of the PHC; (ii) disclose any material information to the investors; (iii) suggest to the Audit Committee the policies of internal controls and internal audit of the PHC and its subsidiaries; (iv) execute the policies defined by the Board of Directors; (v) apply corrective actions; and (vi) guarantee the existence of the accounting, recording, filing and information systems of the PHC.

3.2 How are members of the management body appointed and removed?

The members of the management body are appointed by the shareholders' meeting. A general ordinary shareholders' meeting must be held annually for such purpose or, in its case, to ratify the appointment of the Directors in charge. The general shareholders' meeting resolves any removal of a member of a Board of Directors in both a NPHC and in a PHC.

3.3 What are the main legislative, regulatory and other sources impacting on Directors' contracts and remuneration?

Besides the provisions of the GLBO for a NPHC, and the provisions of the Exchange Act for PHCs, there are no other legislative, regulatory and other sources impacting on the Directors' contracts and remunerations.

3.4 What are the limitations on, and what disclosure is required in relation to, interests in securities held by members of the management body?

A. Restrictions on the Acquisition and Sell of Stock of Related Persons.

A related person, assuming that he/she/it has insider information, cannot acquire, either directly or indirectly, stock of the PHC he/she/it is related with within a 3-month term initiated on the date in which such related person sold stock of the PHC. In the same sense, any related person, assuming he/she/it has insider information, cannot sell, either directly or indirectly, stock of the PHC he/she/it is related with within a 3-month term initiated on the date in which said related person acquired stock of the PHC. For purposes of the Exchange Act, directors of the PHC are considered within the definition of related person. Some exceptions are provided in the Exchange Act in that regard.

B. Transactions that Must be Disclosed. Any person related to a PHC must disclose to the exchange market within the next business day any increase or decrease of at least 5% in his/her/its ownership interest in the capital stock of such PHC and if, so is the case, he/she/it is intending to acquire a Material Influence or increase it. Additionally, any group of persons, directors, or relevant officers

holding at least 10% of the capital stock of a PHC must disclose any acquisition or sale of stock.

3.5 What is the process for meetings of members of the management body?

In NPHCs the Board of Directors' meetings are usually called by the Chairman of Board of Directors or at least 2 members thereof. The GLBO provides that resolutions taken in the meetings of the Board of Directors are valid if at least 50% of the total votes are cast in favour of the corresponding resolution. It is common that all the rules concerning the management body meetings are provided in the corporate bylaws of the NPHC.

Regarding PHCs, Board of Directors' meetings must be held at least 4 times per year. Ideally, the Board of Directors should meet at least once quarterly. The Chairman of the Board of Directors and the Chairman of the Audit Committee and the Corporate Practices Committee may call for Board of Directors' meetings. Moreover, at least 25% of the members of the Board of Directors may call for Board of Directors' meetings as well.

3.6 What are the principal general legal duties and liabilities of members of the management body?

Please refer to question 3.1 above.

3.7 What are the main specific corporate governance responsibilities/functions of members of the management body?

Please refer to question 3.1 above.

3.8 What public disclosures concerning management body practices are required?

The Board of Directors itself has to disclose at least once annually a report on their functions and activities for approval of the shareholders' meeting.

3.9 Are indemnities, or insurance, permitted in relation to members of the management body and others?

Please refer to question 3.1 above.

4 Corporate Social Responsibility

4.1 What, if any, is the law, regulation and practice concerning corporate social responsibility?

There are no mandatory legal provisions regarding corporate social responsibility. However, the Code recommends that Mexican Corporations and other entities have a Board of Directors or equivalent administrative body to discuss and define policies regarding social responsibility.

4.2 What, if any, is the role of employees in corporate governance?

Employees and specifically important officers prepare the information to be submitted for review and approval of the Independent Directors for further approval of the Board of Directors. Some employees are responsible and accountable for the true, sufficient and updated information to be analysed by the shareholders (i.e. financial statements, legal reports, reports on internal controls, etc.).

5 Transparency

5.1 Who is responsible for disclosure and transparency?

The Exchange Act provides that the CEO is responsible for disclosure and transparency in the case of PHCs, since he/she is in charge of the day-to-day operation of the PHC. Such duty must be performed in accordance with the guidelines provided to said officer by the Board of Directors.

5.2 What corporate governance related disclosures are required?

Several accounting, administrative, economic and legal information must be disclosed by the PHC periodically. Depending on the kind of information that is the subject matter of the relevant disclosure to the exchange market, disclosure must be made quarterly, annually or immediately in case of certain material events and corporate acts as provided in the Exchange Act.

5.3 What is the role of audit and auditors in such disclosures?

Financial statements must be audited. The Audit Committee must evaluate periodically the performance of the external auditor and must suggest the candidates for such role for approval of the Board of Directors. The Audit Committee usually meets with the external auditor for such purpose. Not only the Audit Committee but also the CEO and the internal audit department of the PHC verify that the information that is the subject matter of the disclosure is sufficient, updated and true.

The Code recommends that the partner of the entity performing the role of external auditor is rotated periodically at least every 5 years.

5.4 What corporate governance information should be published on websites?

All the relevant information not only regarding corporate governance practices of a PHC must be disclosed to the stock exchange through the World Wide Web for the benefit of investors. That is, all the accounting, administrative, economic and legal information, and any other relevant or material information disclosed periodically must be disclosed via the World Wide Web through a special information system of the BMV (*emisnet*) to which the investors have access.

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